No. 14837

United States
COURT OF APPEALS
for the Ninth Circuit

THE FIRST NATIONAL BANK OF PORTLAND,
a National Banking Association,
Appellant,

vs.

FRANK A. DUDLEY, Trustee in Bankruptcy of the Estate of Northwest Variety Wholesale, Inc.,
Appellee.

BRIEF OF APPELLEE

Appeal from the United States District Court for the District of Oregon.

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BRIEF OF APPELLEE

Appeal from the United States District Court for the District of Oregon.

STATEMENT OF PLEADINGS AND JURISDICTION

Northwest Variety Wholesale, Inc., a corporation, was, by order of the District Court of the United States, for the District of Oregon, upon its voluntary petition adjudicated on the 13th day of July, 1953, to be bankrupt. Thereafter the proceedings were refereed by order of general reference to Hon. Estes Snedecor, Referee in

Bankruptcy of said Court. The Appellant Bank filed its creditor's proof of claim, setting forth that it was a creditor of the Bankrupt in the amount of $8,184.19. The claim so filed disclosed that the claimant Bank had, on July 13th, 1953, appropriated the sum of $2,889.14, then standing to the credit of the Bankrupt in its bank account, toward payment of the indebtedness then due the Bank. The Trustee filed objections to the allowance of the claim of the Bank, claiming that under the circumstances of this case the Bank had no right to set-off said amount against its indebtedness, and asked that the Bank be required to return said amount to the Trustee as a condition to the allowance of its claim. The Bank filed its answer, claiming that it possessed the right of set-off, and upon hearing had, the Referee made his findings of fact and conclusions of law, and based thereon his order denying the claim.

A petition for review of the order of the Referee by the District Judge was filed pursuant to the provisions of United States Code, Title 11, Section 67(c), and, upon hearing of the petition for review, an order was made by the District Court affirming the order of the Referee. Jurisdiction of this Court is based upon the provisions of United States Code, Title 11, Section 47, being Section 24 of the Bankruptcy Act.

STATEMENT OF THE CASE

The findings of fact made by the Referee in his order disallowing claim of the Bank (Tr. 17-22) set forth in detail the facts of this case. These findings, as stated in Appellant's Brief (p. 42) were not and are not contested. During the months of November and December, 1952, the Bankrupt was indebted to the Bank upon a promissory note in the principal amount of $22,000.00. During the month of November, 1952, the Bankrupt became unable to meets its obligations in the regular course of business as they became due, and by its president and its attorney advised the Bank of this condition. At that time the Bankrupt advised the Bank that it had a stock of merchandise which could be sold to advantage over a period of time, so as to liquidate the indebtedness owing by the Bankrupt corporation. The Bankrupt proposed to the Bank that if the creditors, including the Bank, would refrain from seeking immediate payment of their respective accounts in full, the Bankrupt would proceed to liquidate its inventory over a period of twelve months' time, and would pay to the Bank, as well as to other creditors, a quarterly payment of 25% of the indebtedness owing to the Bank and to such creditors, the first of said payments to be made on January 15, 1953.

The Bank proposed a modification in this plan whereby, instead of quarterly payments of 25% over a twelve months' period of time, monthly payment of 10% would be made to creditors, commencing with the month of January, 1953. The Bank agreed that the plan, as so modified, was a feasible one, which would enable

the Bankrupt to work out of its financial difficulties, and that the Bank would go along with the Bankrupt on the plan and refrain from pressing for immediate payment in full of the indebtedness due it, providing that the monthly payments of 10% were made.

The Bankrupt advised its other creditors of the plan, and advised a number of said creditors of the approval of the plan by Bank, and the participation of the Bank therein, and obtained participation of its other creditors in the plan, with the result that the Bankrupt was permitted to continue in business and proceeded with the liquidation of its inventory in accordance with the plan, and made 10% payments monthly to each of its creditors during the months of January, February, March, April and May, 1953.

At the time of the formulation and adoption of the plan the Bankrupt kept, and had for some time kept its bank account at the Bank. After the formulation of the plan the Bankrupt deposited all monies realized from the sale of its inventory in this Bank account, and drew checks upon it in payment of its operating expenses and made payment to its creditors by checks drawn upon the bank account, such payments being made in accordance with the plan to each creditor upon a pro-rata basis of 10% of their respective accounts during the months of January, February, March, April and May, 1953. During this period the Bank had knowledge that the plan was in progress, that the Bankrupt was operating thereunder and that all of the creditors of the Bankrupt had acquiesced in said plain and were receiving their monthly 10% dividends thereunder. At

the time of the commencement of the bankruptcy proceedings there remained in said bank account a balance resulting from said deposits, in the amount of $2,889.14.

The Bank received and accepted the monthly payments of 10% of the principal of its note, together with accruing interest, in full during the five months referred to, and thereby reduced the principal amount of its note from $22,000.00 to $11,000.00. The accounts of the other creditors were reduced on the same pro-rata basis.

After the filing of the petition in bankruptcy in these proceedings, the bank appropriated toward payment of the indebtedness due it the balance of $2,889.14 remaining in the bank account and filed its claim in the amount of $8,184.19. The Trustee, by filing objections to the allowance of said claim, contested the right of the bank under the circumstances of this case to appropriate in partial payment the indebtedness due it, the balance of $2,889.14 in the bank account of the Bankrupt above referred to. The Bank filed its answer to the Trustee's objections, and upon hearing being had, order was entered by the Referee based upon his findings above referred to, disallowing the claim of the Bank unless it surrender to the Trustee the bank account appropriated by it. This order, subsequently affirmed by the District Court upon review, was based upon the conclusions that by its approval of the Bankrupt's plan of payment of its creditors upon a pro-rata basis and by its participation therein, the Bank so dealt with its depositor, the Bankrupt, and with other creditors of the Bankrupt, as to waive or be estopped to assert the right to set-off of the deposits made by the Bankrupt against the indebtedness owing

to the Bank, and that the bank account of the Bankrupt, as it existed at the time of the commencement of the within bankruptcy proceedings, was created under such circumstances, with the cooperation of the Bank and the Bankrupt, as to so far impress upon it the character of a trust fund that the Bank should be estopped to assert a lien thereon, or the right of set-off.

ARGUMENT

Proposition I.

Application of 11 U.S.C.A., Sec. 108, Section 68a of the Bankruptcy Act, recognizing the right of set-off of the mutual debts or mutual credits between the estate of a bankrupt and a creditor will not be made if such application is not in accordance with the general principles of equity.

11 U.S.C.A., Sec. 108, Section 68a of the Bankruptcy Act;

Collier on Bankruptcy (14th Edition) Volume 4, page 710;

Cumberland Glass Manufacturing Company v. Charles DeWitt, 237 U.S. 447, 59 Law Ed. 1042;

Prudential Insurance Company of America v. Nelson (CCA 6th Cir.), 101 F. (2d) 441;

Union Bank and Trust Company of Helena, Montana v. Lester H. Loble, Trustee, 20 F. (2d) 124.

As proposition I of its brief, the Bank contends that a creditor has the right to set-off a debt owing by it to the Bankrupt against a debt owing by the Bankrupt to it; and, if the parties do not effect the set-off prior to

bankruptcy, it is the duty of the Trustee to do so after the bankruptcy. This rule is set forth by statute: 11 11 U.S.C.A., Sec. 108, Section 68a of the Bankruptcy Act. In a proper case it should, of course, be applied.

The Bank contends that this statute should be "liberally construed to effect its purpose." There is no authority for the construction of this statute in any more liberal manner than is required by its express provisions. On the other hand, there is considerable authority to the effect that the application of this statute is governed by principles of equity and fair dealing, depending on the facts of the particular case in which it is invoked.

In the text of Collier on Bankruptcy (14th Edition) Volume 4, page 710, it is stated:

> "Despite the seemingly mandatory language of Section 68a, it has been stated frequently that the privilege of set-off under Section 68a is permissive, not mandatory; and that its application, when invoked before a Court, rests in the discretion of that Court which exercises such discretion under the general principles of equity."

In the case of Cumberland Glass Manufacturing Company v. Charles DeWitt, 237 U.S. 447, 59 Law Ed. 1042, the United States Supreme Court said of Section 68a of the Bankruptcy Act:

> "The provision is permissive rather than mandatory, and does not enlarge the doctrines of set-off and cannot be invoked in cases where the general principles of set-off would not justify it. The matter is placed within the control of the Bankruptcy Court, which exercises its discretion in these cases upon the general principles of equity."

In the case of Prudential Insurance Company of America v. Nelson (CCA 6th Cir.), 101 F. (2d) 441, the Court said regarding the application of Section 68a of the Bankruptcy Act:

> "In all cases of mutual debts, where the insolvency of one of the debtors and the rights of other creditors in the assigned estate are involved, equity intervenes and modifies the legal right of set-off in order to promote equality and justice."

The above authorities and others to the same effect, do not lay down the principles that Section 68a of the Bankruptcy Act is to be "liberally" construed in order to allow the right of set-off claimed by a creditor of the Bankrupt, but, on the contrary, that it is to be construed in such a way as to promote equality and justice in accordance with the principles of equity. It was this rule that was applied by this Court in rendering its decision in the case of Union Bank and Trust Company of Helena, Montana v. Lester H. Loble, trustee, 20 F. (2d) 124, 126, where the Court said:

> "But a bank may so deal with a depositor as to waive or be estopped to assert the right of set-off. Michie, Banks and Banking, 1027. And the right does not exist where the circumstances are inconsistent with its exercise. Neponset Bank v. Leland, 5 Metc. (Mass.) 259; Reynes v. Dumont, 130 U.S. 354, 9 S. Ct. 486, 32 L. Ed. 934. Nor where the principles of legal or equitable set-off do not authorize it. Wagner v. Citizens' & Trust Co., 122 Tenn. 164, 122 S.W. 245, 28 L.R.A. (N.S.) 484, 135 Am. St. Rept. 869, 19 Ann Ca. 483; Furber v. Dane, 203 Mass. 108, 89 N.E. 227; Lyman v. Belfast Nat. Bank, 98 Me. 448, 57 A. 799; In re Davis (D.C. Tex.), 9 Am. B.R. 670, 119 F. 950. On these grounds we think the decision of the Court below is sustain-

able. While the money realized on the special sale and deposited to the bankrupt's current account and subject to its check for general purposes may not be said to come within the accepted definition of a special deposit so as to be exempt from the bank's claim to the right of set-off, we are inclined to the view that the circumstances under which the fund was created, and the co-operation of the bank and the bankrupt in its creation, were sufficient to so far impress upon it the character of a trust fund that the bank should be held estopped to assert a lien thereon or the right of set-off."

The cases cited by Appellant in its brief, are cases where the right of set-off was properly granted. There were no considerations of equity and fair dealing involved. In the case of Studley v. Boylston National Bank, from which Appellant quotes at length (Br. pp. 9-10), there was no suggestion whatsoever of an arrangement or understanding of any kind involving the depositor, the bank, and other creditors. The right of set-off was apparently attacked in that case solely on the ground of the insolvency of the depositor at the time and the bank's knowledge thereof. It is now well established that the right is not vulnerable to such attack. The same is true of the other cases cited by Appellant.

The conclusions in the case at bar in no way controvert the right of set-off of the bank in the ordinary case of mutual debts. Appellant has argued that banking practice will be seriously affected, extensions discouraged, and bankruptcies precipitated in the event that such conclusions are affirmed. There would seem to be no foundation for such argument. All that is held in the case at bar, as in the Loble case heretofore decided by

this Court, is that a bank will be precluded from asserting a set-off where it enters into an arrangement with the depositor and his other creditors involving an extension of time to the depositor to pay his debts, and use of the assets of the depositor for the making of payments to creditors, including the bank, on a pro-rata basis. After such arrangement is entered into, it is not equitable that the bank should obtain payment of a larger proportion of its debts than the other creditors, by exercise of an alleged right to appropriate a portion of the assets of the debtor to payment of its own account to the exclusion of other creditors.

If bankruptcies are to be avoided in the case of embarrassed debtors and extension of time granted to them within which to satisfy their obligation, the participation of other creditors is just as important as that of the bank or banks involved. If such creditors understood that the bank might at any time appropriate to itself the monies placed on deposit with it, with which monies the depositor intended to make pro-rata payments to all in accordance with his agreement, then the participation of creditors would indeed be difficult to obtain. To quote further from the opinion of this Court in the Loble case:

> "Applicable to the case is the language of the Court in Union Trust Co. v. Peck (C.C.A.) 16 F. (2d) 986: 'It is, moreover, to be noted that, before and at the time the bank applied these amounts to its own use, it, the bankrupt, and other creditors were conferring as to the possibility of keeping the bankrupt upon its feet as a going concern by securing the general acceptance of a scheme of reorganization which contemplated the creditors taking less than was due them. Under such circumsances the

deposit by the bankrupt of large sums in the bank, which both it and the bankrupt intended should be used for the reduction of the former's debt, were obviously not made in ordinary course, in any fair sense of that phrase. Most men would feel that it is an implied term of such negotiations that during their pendency nobody taking part in them shall do anything to secure preferential rights in or over any assets of the bankrupt which did not belong to it when the conferences began, or upon which it did not then have a prior lien.' "

Proposition II.

In the case at bar, upon the facts found and admitted, the Bank was properly held precluded to assert a lien or the right of set-off upon the balance in the bank account of the Bankrupt at the date of the filing of the bankruptcy petition herein.

Union Bank and Trust Company of Helena, Montana v. Lester H. Loble, Trustee, 20 F. (2d) 124;
19 Am. Jur. Estoppel, Sections 34 and 35;
31 C.J.S., Estoppel, Section 61;
Re Mauch Chunk Brewing Company, 131 F. (2d) 48;
Wagner v. Citizens' Bank & Trust Co., 122 Tenn. 164, 122 S.W. 245;
Lyman v. Belfast Nat. Bank, 98 Me. 448, 57 A. 799;
In re Davis (D.C. Tex.), 119 F. 950;
Twentieth Street Bank v. Gilmore, 71 F. (2d) 594.

In proposition II of its brief, the Bank contends that it did not so act as to waive or become estopped to assert its right of set-off; in proposition III it contends that the account maintained by the bankrupt at the bank

was not at any time a special deposit or trust fund, nor did it partake of any of the characteristics of either. As in our view, the one question involved is whether, under all the facts of the case, the bank should be allowed to assert its alleged right of set-off, we will deal with these two propositions together.

As will be seen, the Courts in disallowing the right of set-off in certain cases, have not been concerned primarily with whether or not a waiver or an estoppel or a trust fund in the technical sense existed in the particular case. To be sure, in some cases estoppel or waiver or a trust fund in the strictly technical sense has existed. The primary question however, has always been; whether, under the facts of the particular case, it was equitable and in furtherance of the principles of equity and justice that the set-off should be allowed.

In its opinion in the Loble case this Court stated:

> "A bank may so deal with the depositor as to *waive* or be *estopped* to assert the right of set-off."

It is plain from the facts of that case, and the opinion of the Court, that the Court was not employing these terms in any technical sense, but was stating in effect, that the bank under the existing facts was precluded by general principles of equity and fair dealing from asserting such right.

The words "estopped" and "waived" are frequently employed in other than their strictly technical sense. They are words of ordinary usage, not confined to the law. In fact, as used in the field of the law, they are em-

ployed with different meanings in connection with different situations.

In the text of Am. Jur. cited by Appellant, on the subject of Estoppel, Sec. 35, it is stated:

> "Equitable estoppel is distinguished from technical estoppel in that it arises out of the acts and conduct of the party estopped and not from a record or a deed. It differs also in certain particulars from various legal bars which are in some respects analogous to it and which have substantially the same practical operation and to which the term 'estoppel' is frequently applied, but which are more properly designated as 'quasi estoppels'. Quasi estoppels include such matters as the doctrine of 'election', the principle which precludes a party from asserting to another's disadvantage a right inconsistent with a position previously taken by him, waiver, ratification, and laches."

In Sec. 36 of the same text it is stated:

> "The terms 'estoppel' and 'waiver' are often used interchangeably, particularly with reference to situations arising under insurance policies. . . . The dividing line between estoppel and express waiver is not difficult to preserve, but the line is somewhat less distinct between estoppel and waiver implied from conduct."

In the text of 31 C.J.S. on the subject of Estoppel, also cited by Appellant, in Sec. 61, in distinguishing estoppel from waiver, the text gives the following as one of the definitions of waiver:

> "Waiver is the intentional relinquishment of a known right, or such conduct warrants an inference of the relinquishment of such right."

It is further stated in the same section:

> "Although the word (waiver) is flexible and not

always definite, it is capable of taking on a very definite meaning from its context. The doctrine of waiver is often difficult of application; and the question of whether a waiver is present in any particular case must be decided on the facts peculiar to that case."

In the case of re Mauch Chunk Brewing Company, 131 F. (2d) 48, denying the Bank's claim of set-off under the facts of that particular case, the Court said:

"Section 68 of the Bankruptcy Act allows a creditor to set-off, if certain conditions of that section are met, mutual debts existing between him and the debtor. This is a privilege which the creditor may or may not claim. If it is not asserted, it is lost. Likewise, if the creditor's conduct is inconsistent with a subsequent claim of set-off, he is held to have waived it."

While in the Loble case there was no technical trust fund but only a general account as in the case at bar, and there was no evidence of all the requirements of technical equitable estoppel as set forth in Appellant's brief, the Court said:

"While the monies realized on the special sale and deposited to the bankrupt's current account and subject to its checks for general purposes may not be said to come within the accepted definition of a special deposit so as to be exempt from the bank's claim to the right of set-off, we are inclined to the view that the circumstances under which the fund was created, and the cooperation of the bank and the bankrupt in its creation, were sufficient to so far impress upon it the character of a trust fund that the bank should be held estopped to assert a lien thereon or the right of set-off."

When the Bankrupt first made its proposal to the Bank, and later to its other creditors, the note of the

Bank was past due. The Bank lays considerable stress upon the fact that at that time it could have exercised a right of set-off against the account of the Bankrupt then on deposit with it. This, while true, would seem to be wholly immaterial. The exact amount in the bank account of the Bankrupt at the time that the proposition for settlement of its obligations was first presented to the Bank, or at the time that the Bank signified its agreement "to go along with the Bankrupt on the plan", is not determinable from the record. The Bank's Exhibit 5 shows that in the month of November, 1952, during which month the Bankrupt took the matter up with the Bank, and requested its acquiescence in the plan, the highest amount in the bank account of the Bankrupt was $13,285.75, and the lowest amount was $7,621.16. When the proposition was presented to it, the Bank was confronted with the necessity of making a decision whether or not to agree to the plan, and whether or not to exercise its existing legal rights. The Bank at that time, no doubt, weighed the fact that it had a right of off-set, the exercise of which would still leave a very substantial amount of its indebtedness, and perhaps the bulk thereof, owing to it. The Bank elected not to exercise its right of set-off against the existing account and to go along with the plan, and so advised the Bankrupt.

The Bankrupt then advised its other creditors of the terms of the plan and that the Bank, as its largest creditor, had agreed to participate therein. These other creditors were then confronted with the necessity for the making of a decision, the same as the bank had been. The decision to be made was, as in the case of the bank,

whether or not to immediately exercise legal right or permit the Bankrupt to carry out, or attempt to carry out the terms of its proposal. All of the creditors did acquiesce in the plan. It is a fair inference to make that in so doing they were influenced by the information given to them that the Bank, as the largest creditor, had acquiesced in the plan.

The plan referred to provided for the conversion of tangible assets of the Bankrupt, its stock of goods, wares and merchandise, to cash, to provide funds out of which the indebtedness owing to creditors could be paid over a period of ten months by ten equal monthly payments, commencing with payment of January 15, 1953. The Bankrupt proceeded to act under this plan and made the agreed monthly payments to its creditors, including the Bank, during the months of January, February, March, April and May, 1953, the Bank receiving during this time $11,000.00, or 50% of its indebtedness, together with interest thereon. This may have been substantially more than the Bank could have realized by exercise of its right of off-set in November, 1952, at the time that the Bankrupt first informed the Bank that it could not continue in business and satisfy its obligations in the regular course, but would have to have an agreement with its creditors for allowance of time to convert the tangible assets into cash. In March, 1952, the Bank account of the Bankrupt, as shown by Exhibit 5, reached a low point of $481.05 over-draft, by which time all monies originally subject to the Bank's right of off-set in November, 1952, had long since been exhausted. Sub-

sequent deposits were made by the Bankrupt from the proceeds of the continued operation of its business under the plan of extension, and were drawn upon to pay operating expenses and pro-rata payments to creditors in accordance with the terms of the plan of extension, until such time as the bankruptcy petition was filed herein.

It is submitted that under these facts: "The circumstances under which the fund was created, and the cooperation of the Bank and the Bankrupt in its creation were sufficient to so far impress upon it the character of a trust fund that the Bank should be held estopped to assert a lien thereon, or the right of set-off."

The above quotation is from the case of Union Bank and Trust Company v. Loble, decided by this Court upon facts similar to those in the case at bar. The facts of that case and the attempt of the Bank to distinguish that case from the case at bar will hereinafter be discussed.

In the case of Wagner v. Citizen's Bank & Trust Co. (122 Tenn. 164, 122 S.W. 245), cited by this Court in the Loble case, the trustee in bankruptcy had filed a suit to recover from the Bank the balance in the Bankrupt's bank account, which the Bank endeavored to off-set. The complaint alleged that the fund was impressed with the character of a trust fund and was accumulated under circumstances which fixed upon the defendant Bank the character of a trustee in relation to the fund. It was alleged that the money was accumulated as a result of an agreement among the creditors of the Bankrupt, including defendant Bank, to the effect that the assets of the

Bankrupt should be collected and the proceeds deposited in the defendant Bank and distributed pro-rata among all the creditors. It was claimed that under the facts set forth the Bank was "estopped from appropriating said funds to its own use, to the exclusion of other creditors."

The Court's statement of the facts discloses a familiar pattern arising when a debtor becomes unable to take care of his obligations. The creditors held a meeting, inquired into the financial condition of the company, and extended time to it to take care of its obligations. When the company became still further embarrassed, the creditors decided that the assets of the company should be reduced to cash, which should be deposited in the company's bank account, and only such sum thereof used as might be necessary to defray current expenses and satisfy the claims of persistent creditors, and the surplus, after the accumulation of sufficient funds, should be divided pro-rata among all the creditors. The Bank participated with the other creditors in these proceedings. The Court stated:

> "We find from the proof that the fund which the bank is now seeking to set-off against the indebtedness due it from the furniture company was accumulated as the result of the auction sales, and that it was understood by the defendant bank that this fund was deposited with it as a special fund for pro-rata distribution among all the creditors of the Wilcox Furniture Company."

The Bank contended for its right to appropriate the balance in the bank account to satisfaction of the indebtedness due it from the debtor. The Court, after recogniz-

ing the Bank's right to set-off in the ordinary case, proceeded to the examination of several authorities setting forth special circumstances under which the alleged right had been disallowed, and concluded its opinion by stating:

> "We are, therefore, of opinion that the Bank is estopped, by its conduct and by its agreement with the other creditors, from asserting any right to a set-off against the funds derived from the sales of the stock of the furniture company."

Among the cases examined was that of Lyman v. Belfast National Bank (98 Me. 448, 57 A. 799), also cited by the Court in the Loble case. In that case the debtor sent to each of its creditors, including the Bank, a circular letter stating that it was unable to meet its obligation. Later it called a meeting of its creditors, at which the Bank was represented. No extension of time was ever granted by the creditors. Pending the negotiations, the debtor deposited in its bank account at the Bank the sum of $800 cash which it had on hand.

The Court said of the Lyman case:

> "For some time past all the efforts of the granite company . . . and that of its creditors had been to obtain a distribution of its assets equitably, and to that end the first attempt was to discourage the attachments. Honest dealing on the part of the granite company, which is to be presumed, required that all of its assets should be husbanded for the benefit of all of its creditors. Pending the effort to obtain an assignment or adjudication of bankruptcy it had $800 in money, which it intended to retain, and ought to retain, as part of its general assets. As some time would elapse before it could be thus administered, it was deposited in the bank really for

safekeeping. All these facts were well known to the bank when it received the deposit. It knew it was not intended as a payment and did not treat it as such. The bank could not fail to understand that it was intended that this money should be added to the other assets for the general benefit as it equitably ought to be. It certainly understood that the granite company, under the then existing circumstances, would not voluntarily subject this portion of its assets to a set-off by the bank to the injury of other creditors. Upon consideration of all the circumstances, and the situation of the parties, we think it a fair inference that the bank understood that the deposit was intended only for safekeeping, to be ultimately appropriated for the benefit of all the creditors of the granite company, and that in fact it was a deposit in trust for that purpose. And it being charged with such trust, the plaintiff, as trustee in bankruptcy, its entitled to recover."

The case of In re Davis (119 F. 950) also cited by the Court in the Loble case, was cited by the Court in the Tennessee case, with the following quotation therefrom:

"But upon the merits of the controversy, would the bank be in a position to successfully contest the right of the trustee to the money? Its ability to do so would depend upon its right to apply the fund to its own use. While a general deposit by a merchant of money in a bank creates the relation of debtor and creditor, and authorizes the bank to use the money as its own, such result does not obtain when the deposit is made for a special purpose—as, for example, to be paid to creditors, as was the case here."

In the case of the Twentieth Street Bank v. Gilmore (1934 CCA W.Va.), 71 F. (2d) 594, the Court, after stating the general rule that a Bank may set-off a de-

posit made in the ordinary course of business and subject to withdrawal by the depositor, even though the Bank may know that the depositor is insolvent at the time, the Court went on to cite many cases where, under the facts of the particular case, the right of set-off was denied to the Bank. Among the cases cited was the Loble case, where the holding was stated to be that "the circumstances under which the funds deposited were raised and the co-operation of the Bank with the depositor so far impressed them with a trust as to estop the Bank from asserting its right of set-off."

The following is quoted from the opinion of the Court to the case last referred to of Twentieth Street Bank v. Gilmore:

> "But, in order that the bank may invoke this rule, the deposit must have been made by the depositor, in the ordinary course of business. The right of set-off does not exist if the bank accepts the deposit knowing that it is made for a special purpose or is subject to a trust for the creditors of the depositor. Thus the right of set-off was denied in Merrimack Nat. Bank v. Bailey (CCA 1st) 289 F. 468, 5 ABR (NS) 663; id. (DC) 283 F. 514, 49 ABR 232, where the deposits were made in the regular course of business by the corporation, but after a creditors' committee, on which the bank was represented, had taken over the business following an agreement of creditors for an extension of credit. Such right was likewise denied in Union Bank & T. Co. v. Loble (CCA 9th) 20 F. (2d) 124, 10 ABR (NS) 350; Union Bank & T. Co's. Petition (DC) 14 F. (2d) 116.8 ABR (NS) 571, where the deposits were the proceeds of a sale to raise funds for Eastern creditors, and it was held that the circumstances under which the funds deposited were raised and the co-operation of the bank with the depositor so far im-

pressed them with a trust as to estop the bank from asserting its right of set-off. A like result was reached by Judge Groner in Gates v. First Nat. Bank (DC) 1 F. (2d) 820, 2 ABR (NS) 507, where the deposits were made after the depositor had suspended business and its affairs were being investigated by a creditors' committee of which the Vice President of the bank was a member. And this court in Union Trust Co. v. Peck (CCA 4th) 1 F. (2d) 986, 987, 9 ABR (NS) 127, denied the right of set-off where the deposits were made while creditors were conferring as to the adoption of a plan of reorganization. See also First Nat. Bank v. Sheely (CCA 5th) 29 F. (2d) 400, 13 ABR (NS) 72; in Re Davis (DC) 119 F. 950, 9 ABR 670; and Wagner v. Citizens' Bank & T. Co. 122 Tenn. 164, 122 S.W. 245, 28 LRA (NS) 484, 135 Am. St. Rep. 869, 19 Ann. Cas. 483.

'In the case at bar, the committee of creditors, of which the president of the bank was a member, had decided that no payments were to be made from the proceeds of its operation of the business on the larger debts of the milling company, which included the indebtedness due the bank, but that collections were to be used for the purpose of running the business and for the benefit of creditors generally. Later, when bankruptcy seemed inevitable, the committee directed that nothing be paid on indebtedness, but that collections be pressed and the money realized therefrom be deposited so that the Court, and not the committee, might decide as to its application. Under such circumstances, the deposits made were clearly not deposits in the ordinary course of business by the milling company, and certainly the bank, after acquiescing in the plan of the committee, was estopped from claiming that it had the right to seize deposits made with it in the carrying out of this plan and apply them on debts of the bankrupt owing to itself. As said by Judge Rose in Union Trust Co. v. Peck, supra: 'Most men would feel

that it is an implied term on such negotiations that during their pendency nobody taking part in them shall do anything to secure preferential rights in or over any assets of the bankrupt which did not belong to it when the conferences began, or upon which it did not then have a prior lien.' "

Proposition III.

Upon principle, the case at bar is not distinguishable from the case of Union Bank and Trust Company of Helena, Montana v. Loble (9th Cir.) 1927, 20 F. (2d) 124, in which the right of set-off was denied to the Bank.

> Union Bank and Trust Company of Helena, Montana v. Lester H. Loble, Trustee, 20 F. (2d) 1924 (9th Cir. 1927).

As its proposition IV, the Appellant Bank contends that the case of Union Bank and Trust Company of Helena, Montana v. Loble, 9th Cir. 1927, 20 F. (2d) 124, does not constitute authority for denial of the Bank's alleged right of set-off in this case, and endeavors to distinguish the facts of the Loble case from the facts in the case at bar.

It is, of course, too much to expect that the exact factual situation should exist in each case. It is submitted, however, that the factual differences that do exist are wholly immaterial, and that the facts of each case require the application of the same principles and the same result in the decision of the case.

Appellant speaks of the facts of the Loble case as found by the District Court (App's. Br. 25-27) and states p. 27) that this Court accepted the facts as found

by the Referee and affirmed by the District Court. There were no findings of fact made by the Referee or District Court upon the matters which this Court found controlling in arriving at its decision.

As stated in the opinion written by this Court, at page 125:

> "All that the Referee found was that the bankrupt 'was insolvent at the time of such transfer and deposit, and that the bank knew, or had reasonable cause to know, that the effect of taking said money and paying said debt to itself would be that it would receive a greater percentage of the assets of said bankrupt than any other creditor of the same class, and that said bank knew, or had reasonable cause to know, that said bankrupt was insolvent at the time said transfer was made and prior thereto.' "

This Court held that the conclusion of the Referee and of the Lower Court could not be sustained on the grounds given in the opinion of the Lower Court, and proceeded to examine the facts of the case as disclosed by the testimony. Accordingly, the facts are stated somewhat differently in the opinion of this Court than in the opinion of the Lower Court; and as the facts stated in the opinion of this Court are based upon an examination of the testimony and not upon any findings of fact of the Lower Court, it is to be assumed that the opinion of this Court correctly states the facts of this particular case, as well as the law applicable thereto.

In the conclusion of its argument (App's. Br. 42) Appellant states that in the case at bar it was the District Court's feeling, as evidenced by its memorandum of decision that inasmuch as the Referee regarded this

case as being controlled by the Loble case, it would not be inappropriate for this Court which decided the Loble case, to point out wherein the two cases may be distinguished. We know of no such feeling on the part of the Court, and certainly no such feeling is evidenced by the memorandum of decision. In this memorandum (Tr. 27) the Court did state that: "I do not feel that I should strain to distinguish the Loble case, and I will follow the view the Referee took of it."

Appellant has so strained in its Proposition IV to distinguish the two cases. Most of the factual differences pointed out, seem to us to be wholly immaterial. Some of them, in our interpretation of the facts as stated in the opinion of this Court, do not exist. We will follow Appellant's outline, by which attempt was made to distinguish the two cases.

Loble Case	*This Case*
1. At the time of the agreement the Bankrupt owed the Bank $10,000 on a 90-day renewal note. It is not stated whether the note was in default.	1. At the time the extension was granted the Bankrupt owed the Bank $20,000 on a note which was in default.

It, of course, can make no difference whether the indebtedness owing the Bank is $10,000 or $20,000 (actually $22,000 in this case), or any other figure. Nor can it make any difference whether or not the note was in default at the time of the agreement for extension of time. No statement is made in the opinion of either the Lower or Appellate Court as to this fact; but, in view of the statement of the Lower Court that the Bankrupt

was at the time, "without funds, insolvent, pressed by creditors, suspension of business imminent, and in extremis", it is the more logical assumption that the note was in default.

2. The Bankrupt not only had no balance in its account, it was indebted to the Bank on an overdraft in excess of $1000.	2. The Bankrupt had a balance in its account ranging from $8165.79 to $22,301.09 during December, 1952. The exact date of the discussion between the representatives of the Bankrupt and the Bank is not in the record.

What difference can it make in the application of the principles involved, that the bank account was in one case greater than in the other at the time the agreement was entered into. Evidently the point that Appellant Bank wishes to make, is that it was in a position to exercise a right of off-set at the time that it elected not to do so and entered into the extension agreement. It is clear from the record that during the month of December, 1952, the extension plan was already in operation. The Bankrupt had taken the matter up with the Bank in November, 1952 (Order Disallowing Claim, Tr. 18). In that month the high balance in the bank account of the Bankrupt was $13,285.75 and the low balance $7,621.16 (Claimant's Exhibit No. 5, Tr. 61). In the next month, after the extension plan was put in operation, the high balance increased to $22,328.59, and increased again in the ensuing month to $25,897.57. The amount which the Bank might have realized upon its indebtedness by exercising its right of off-set, had it elected to do so, is conjectural. However, it is also wholly immaterial. What

is material, is that the Bank elected not to exercise such right of off-set, and to go along with other creditors upon the extension plan proposed by the Bankrupt.

3. After a series of conferences initiated by the Bank, a plan formulated and presented by the Bank was adopted at the insistence of the Bank, resulting in an agreement between the Bankrupt, the Bank and creditor - relatives of the Bankrupt's management.	3. The Secretary-Treasurer of the Bankrupt and its attorney called on an officer of the Bank to advise him of the Bankrupt's financial condition. They suggested that if the excessive inventory were liquidated in the normal course of business, rather than as salvage stock, they thought the corporation would be able to continue its operation. They suggested that the Bankrupt make quarterly payments to its creditors of its outstanding obligation. The Bank stated that quarterly payments would not be acceptable but that if the Bankrupt made payment in liquidation of its obligation owing the Bank of 10% per month commencing in January, 1953, the Bank would defer any action on the obligation, but only for so long as the monthly payments were made.

Appellant Bank has repeatedly stressed, as an important factual difference, that in the Loble case the plan was formulated and presented by the Bank; while in the case at bar it was presented, in the first instance,

by the Bankrupt. It is submitted that this is an immaterial factual distinction. Certainly the rights of the parties in this case should not turn upon who originally proposed the plan which the parties adopted, and partially executed. In fact, in this case, the Bank did not like the plan originally presented to it, and suggested a modification, which was adopted.

4. The agreement between the Bankrupt, the Bank and the creditor-relatives was: (a) To have an extraordinary sale; (b) The proceeds of the sale to pay "urgent Eastern creditors" (14 F. 24 117). The purpose of the sale was to create a particular fund for a particular purpose. (c) To deposit proceeds of the sale in the Bank.	4. There was no agreement in the sense the term was used in the Loble case. The Bank granted an extension of time to the Bankrupt within which to liquidate the obligation, expressly conditioned on the prompt payment by the Bankrupt of 10% of the obligation each month commencing January 15, 1953. The extension agreement did not earmark the deposit for any particular purpose.

There was just as much of an agreement in the one case as in the other. The Bankrupt agreed to liquidate its stock in a certain manner, and to treat all creditors alike, by making a payment to each of them monthly of 10% their respective accounts. The Bank agreed to "go along with the Bankrupt on the plan and refrain from pressing for immediate payment in full of the indebtedness due it, providing that the monthly payments of 10% were made." (Tr. 18, 19). The purpose of the agreement in this case was certainly just as in the Loble case, to create a particular fund for a particular purpose.

In this case the purpose of the creation of the fund was clearly expressed, that is, to pay all creditors alike, 10% of the amount of their respective accounts monthly. The bank account was just as much earmarked for a particular purpose in the one case as in the other. In neither case was a special account created. In both cases the proceeds of the sale were deposited in the regular pre-existing general bank account of the Bankrupt, and were subject to withdrawal upon the checks of the Bankrupt alone.

5. At the date of the exercise of the right of set-off, the Bankrupt's account had increased from approximately a $1,000 deficit to an $8,378.56 credit.	5. At the date of the exercise of the set-off, the Bankrupt's account had decreased from a sum between $8,000 and $22,000 to $2,889.14.

As stated under number 2 above, the bank account actually decreased from the time the extension plan was entered into to the date of bankruptcy, from between $7,621.16 and 13,285.75 to $2889.14. As we have before stated, however, the exact amounts are in our view immaterial. The Bank did not exercise any right of off-set against the bank account as it existed in November and December, 1952, but did endeavor to exercise such a right of off-set against the account as it existed several months after the plan of extension had been put into effect, and the Bank had enjoyed the fruits of the plan by receiving payment thereunder of the sum of $11,000, together with interest.

6. A fund was created by the operation of the agreement.	6. An existing fund was depleted during the liquidation program adopted by the Bankrupt.

Appellant Bank can only mean that the Bankrupt had more money in its bank account when the extension agreement went into effect than it did at the time of bankruptcy. A fund was, of course, created by the operations under the plan of extension. This fund was paid out to creditors of the Bankrupt, resulting in payment to each of them 50% of his account, including payment of $11,000, plus interest, to the Bank. This amount may, or may not, have been more than the Bank could have realized had it elected to exercise its right of off-set in November, 1952. In March 1953, the bank account of the Bankrupt, as shown by Exhibit 5, reached a low point of $481.05 overdraft, by which time all monies originally subject to the Bank's right of off-set in November, 1952, had long since been exhausted. Subsequent deposits were made by the Bankrupt from the proceeds of the continued operation of its business under the plan of extension.

7. The Bank refused to allow the funds to be used to pay Eastern creditors, as contemplated by the agreement (14 F. 117) apparently because the Bankrupt had presented an alternative plan to it involving the payment of 25% to each creditor. (20 F. 2d 125). The Bank breached the agreement by diverting the funds in the account (which had been created for a special purpose) to its own use, contrary to the agreement.

7. The Bankrupt failed to comply with the condition on which the extension of time was granted by not making the June payment, and by filing its voluntary petition in bankruptcy.

The Bank in the Loble case made no more of a diversion of the funds in the bank account than did the Bank in the case at bar. In both cases the Bank endeavored to exercise a right of off-set in its own favor when the plan of operation, under which the bank account was created, was not carried out by the Bankrupt. This Court in its opinion in the Loble case stated: "While the money was in its possession on deposit, the Bank placed no obstacle in the way of its disbursement to Eastern creditors until early in January, when it became apparent that the suggested plan of reorganization had failed. Thereafter the Bankrupt presented to the Bank a proposition to compromise with all creditors on the basis of twenty-five cents on the dollar. The Bank denied the Bankrupt's right thus to use the money on deposit, and asserted its own claim of lien thereon."

Likewise in the case at bar, the Bank placed no obstacle in the way of disbursement of the funds contain-in the bank account until after the plan of extension had failed in that the Bankrupt was no longer able to perform under it.

8. The Bank asserted the setoff before the petition in bankruptcy was filed.	8. The Bank exercised the set-off after the petition in bankruptcy was filed.

We can imagine no basis whatsoever for treating the two cases differently on this account. The right of set-off, if it exists at all, is not dependent upon a petition in bankruptcy having been filed.

9. The account was created for a specific purpose	9. The account was created some six years prior

and the Bankrupt was expressly limited by the agreement between the parties from making any withdrawals from it except as authorized by the agreement.

to the financial difficulty of the Bankrupt and continued until the right of set-off was exercised. As specifically found by the Referee, there was no change of any kind in the account or the manner in which or the terms upon which it was operated or maintained. The extension agreement did not provide that the future deposits should be used for any specific purpose.

There is no basis whatsoever for the statement that the Bank account in the Loble case was created (if by this is meant newly established or opened) as a part of the agreement that was entered into. The bank account was a general pre-existing bank account in both cases. As stated by the Court in its opinion: "The special sale was had, and during the months of December and January the Bankrupt deposited the proceeds thereof to its account in the bank, *subject to check in the same manner as money it had previously deposited.*" Nor is there any basis for the statement that the Bankrupt in the Loble case was expressly limited by the agreement between the parties from making any withdrawals from it, except as authorized by the agreement. As stated by the opinion of this Court: "The Bank never refused to honor any checks drawn by the Bankrupt, and during December and January it paid out thereon, as the Court below found, about $4,708, or about one-third of the money realized upon the sale, none of it to pay Eastern cred-

itors, but principally to pay relatives, local creditors and current expenses."

Appellant proceeds to cite and discuss various cases in which reference was made to the Loble case. None of these cases criticize the holding of the Loble case. In the case of Ingram v. Bank of Cottage Grove, the bank participated in no plan of extension. In fact there was none. This again was simply a case where the depositor became financially involved to the knowledge of the bank, and the Court held that this alone did not affect the bank's right of set-off. It is a far different situation in the case at bar where the bank participated in the plan of extension and accepted its benefits over a period of several months.

The same may be said of the cases of Killoren v. First National Bank of St. Louis, Citizens National Bank of Gastonia v. Lineberger, and Twentieth Street Bank v. Gilmore. They are cases sustaining the bank's right of set-off under the facts of those cases which presented no situation remotely similar to that in the Loble case and in the case at bar. All of these decisions impliedly approved the holding of the Loble case as applicable to the facts of that case.

In the Killoren case in which the Loble case was discussed and held inapplicable as authority in the case then before the Court, the Court pointed out that in the Killoren case the Bank had made no agreement whatsoever with the depositor, stating at page 540 of the opinion:

"It requires no fine analysis or sifting of the evidence to demonstrate that the Court was correct in finding that while there was some conversation between the representatives of Commercial Factors Corporation and officers of the bank with reference to the question whether the Shoe Company would be able to meet its payrolls on April 15, the Shoe Company made no agreement whatever with the bank relative to the deposit, indicating that it should be applied or allocated to any special purpose."

CONCLUSION

We are at a loss to understand why counsel for Appellant in the conclusion of their brief ascribe to us the "preposterous" argument that they there do. We have at no time in the course of this litigation contended, as stated by counsel, that an extension of time within which to pay a delinquent obligation operates as an absolute waiver of the right to proceed to the collection of the obligation, "even though the extension is conditioned upon periodic payment on the delinquent obligation."

The uncontroverted finding of the Referee was that the Bank agreed to go along with the plan and refrain from pressing for immediate payment in full of the indebtedness due, providing that the monthly payments of 10% were made. The same condition attached to the obligation of every other creditor participating in the plan. At any time that the condition of monthly payment was not met each creditor could if he saw fit press for immediate payment, but this does not mean that the Bank could then appropriate the bank account that had been accumulated under the operation of the plan toward

payment of its own obligation to the exclusion of the other creditors.

In reading the short transcript of testimony and considering it as a whole, one can hardly escape the conclusion that the Bank not only entered into the plan of liquidation and payment but dictated some of its terms. It participated in the plan with full knowledge that other creditors likewise were participating and that each and all were relying upon the good faith of the debtor and of the creditors to carry out the plan. All creditors were treated alike, except that the Bank received accruing interest in addition to the 10% monthly payments on the principle. All creditors received the benefit of the orderly liquidation. The debtor in good faith reduced its staff to minimize the expense of liquidation. The bank account was used for the purpose of paying the expenses of administration and distributing the funds proportionately to the creditors. For several months prior to bankruptcy the bank account was used for no other purpose than to pay the expenses of liquidation and to distribute the funds proportionately to the creditors.

In any plan designed to enable a financially distressed person or business to work out of its distressed condition with the cooperation of its creditors, the cooperation of merchandise and service creditors, is just as necessary as is that of a bank creditor. The creditors were all advised that the inventory of the Bankrupt would be disposed of and the net proceeds of the sale distributed to creditors, including the Bank, on a pro-

rata basis. If the letter to the creditors, requesting their participation in the plan, had stated something to the effect that the proceeds of the sale of the inventory would be deposited in the Bank and that the Bank reserved the right at any time to seize such proceeds and apply them in payment of its indebtedness in preference to that of other creditors, the degree of cooperation obtainable from these other creditors can well be imagined.

We submit that the conclusion of this Court in the Loble case is sound. It is based on consideration of equity and upon adequate authority. It has not upset banking practice and has not precipitated bankruptcies. We submit further that the facts of the case at bar require the same conclusion reached in the Loble case that, "the circumstances under which the fund was created, and the cooperation of the Bank and the Bankrupt in its creation, were sufficient to so far impress upon it the character of a trust fund that the Bank should be estopped to assert a lien thereon or the right of set-off."

We submit that the attack of the Bank upon the conclusions and order of the Referee and upon their affirmance by the District Court, is not merited, and that the order of the Lower Court should be affirmed.

Respectfully submitted,

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